ISDA. Safe, Efficient Markets

February 19, 2016

Robert deV. Frierson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

By email: regs.comments@federalreserve.gov

Re: Comment Letter on Federal Reserve Board Proposed Rules Regarding Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements

Ladies and Gentlemen:

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] appreciates the opportunity to comment on the notice of proposed rulemaking (the "**U.S. TLAC Proposal**") promulgated by the Board of Governors of the Federal Reserve System (the "**Board**") regarding total loss-absorbing capacity, long-term debt and clean holding company requirements for systemically important U.S. bank holding companies ("**Covered BHCs**") and the intermediate holding companies of systemically important foreign banking organizations ("**Covered IHCs**").[2]

Our comments on the U.S. TLAC Proposal are focused on certain of the "clean holding company" requirements applicable to Covered BHCs and Covered IHCs that would appear to be in conflict with the aims of the ISDA 2015 Universal Resolution Stay Protocol (the "**ISDA 2015 Universal Protocol**") as well as regulations that are expected to be adopted in the United States that separately address stays on insolvency-based cross defaults in financial contracts. As we discuss in greater detail below, ISDA urges the Board to harmonize the final TLAC rules with such regulations.

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1 Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Additional information on ISDA is available at www.isda.org.

2 80 Fed. Reg. 74926 (November 30, 2015).

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I. Background

In November 2015, ISDA published the ISDA 2015 Universal Protocol, which was adhered to by twenty-one major global banks at its launch.[3] The ISDA 2015 Universal Protocol was developed by ISDA and a working group of its members in close coordination with the Financial Stability Board and national regulators, including the Board, with the aim of improving the resolvability of financial institutions.

One of the core features of the ISDA 2015 Universal Protocol is an agreement by adhering parties not to exercise certain cross-default rights in agreements covered by the ISDA 2015 Universal Protocol if their counterparty's parent company enters insolvency proceedings under the U.S. Bankruptcy Code (the "**Code**"), subject to certain conditions (the "**Bankruptcy Code Provisions**").[4] The Bankruptcy Code Provisions strike a balance of permitting counterparties to retain insolvency-based cross-default rights in their financial agreements but imposing restrictions on their ability to exercise those rights if doing so would undermine the orderly resolution of the counterparty's parent company. These Bankruptcy Code Provisions are based in large part on the stay provisions contained in Section 210(c)(16) of Title II of the Dodd-Frank Act (the "**Orderly Liquidation Authority**"). The ISDA 2015 Universal Protocol currently applies to over-the-counter derivative transactions entered into under ISDA Master Agreements and repurchase transactions and securities lending transactions entered into under certain industry-standard master agreements.[5]

II. The Board Should Modify the Clean Holding Company Requirements to Match Forthcoming Resolution Stay Regulations

The ISDA 2015 Universal Stay Protocol and the Bankruptcy Code Provisions in particular are the product of more than two years of negotiations in which Board staff were active participants and that also involved other U.S. and international regulators as well as sell-side and buy-side members of ISDA. These negotiations were undertaken to identify the conditions that

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[3] The ISDA 2015 Universal Protocol replaces in its entirety the ISDA 2014 Resolution Stay Protocol that was published by ISDA in November 2014 (the "**ISDA 2014 Universal Protocol**") with respect to any two adhering parties to the ISDA 2014 Universal Protocol that adhere to the ISDA 2015 Universal Protocol. Therefore, we refer to the ISDA 2015 Universal Protocol throughout this letter unless the context requires otherwise. See "Major Banks Sign Relaunched ISDA Resolution Stay Protocol," November 12, 2015, available at http://www2.isda.org/news/major-banks-sign-relaunched-isda-resolution-stay-protocol.

[4] See ISDA 2015 Universal Protocol, Section 2. For example, if Party A entered into an over-the-counter derivative with Party B and benefitted from a guarantee from Party B's parent company, if the derivative was subject to the ISDA 2015 Universal Protocol, Party A's right to terminate the derivative upon the parent company's entry into proceedings under the Code would be stayed and in certain cases entirely overridden, subject to certain conditions.

[5] The International Capital Market Association, International Securities Lending Association and Securities Industry and Financial Markets Association, in consultation with ISDA, developed an annex to the ISDA 2015 Universal Protocol that expands the scope of agreements subject to the ISDA 2015 Universal Protocol to repurchase transactions and securities lending transactions entered into under certain master agreements published by those associations.

regulators, including staff of the Board, determined to be sufficient to facilitate the orderly resolution of a financial institution under the Code while maintaining important creditor protections in the event that a U.S. financial institution entered insolvency proceedings.

Although the ISDA 2015 Universal Protocol is currently a contractual arrangement among global banking institutions, the Bankruptcy Code Provisions were developed with the expectation that they would be consistent with regulations adopted in the United States that would require financial institutions to include such provisions, or similar terms, in their financial arrangements with market participants more broadly ("**U.S. Resolution Stay Regulations**").[6] In fact, the Bankruptcy Code Provisions only become effective for those entities that have already adhered to the ISDA 2015 Universal Protocol once U.S. Resolution Stay Regulations are effective.[7]

However, as currently drafted, certain of the clean holding company requirements in the U.S. TLAC Proposal are inconsistent with the Bankruptcy Code Provisions and as such, the expected U.S. Resolution Stay Regulations. Because U.S. Resolution Stay Regulations are expected to reflect the extensive work that regulators and industry participants have done to address stays on cross-default rights, we urge the Board to align the final TLAC rules with such U.S. Resolution Stay Regulations. We note that at this time, there is no consensus among ISDA's members about what the final U.S. Resolution Stay Regulations should provide and members articulated a variety of perspectives during the development of the ISDA 2015 Universal Protocol. However, there is a clear consensus that the final TLAC rules should not be inconsistent with the U.S. Resolution Stay Regulations.

In particular, the U.S. TLAC Proposal prohibits Covered BHCs and Covered IHCs from guaranteeing a liability of an affiliate if such liability permits the "exercise of a default right that is related, directly or indirectly, to the [Covered BHC or Covered IHC] becoming subject to a receivership, insolvency, liquidation, resolution or similar proceeding other than a receivership proceeding under [the Orderly Liquidation Authority]"[8] (the "**Prohibition on Guarantees**"). The Prohibition on Guarantees is in conflict with the Bankruptcy Code Provisions, which would allow such U.S. financial institutions to guarantee the obligations of affiliates, even if those obligations contained insolvency-based cross-default provisions, so long as the affiliate's counterparty agreed to the stay and possible override of the exercise of its rights if the U.S. financial institution became subject to proceedings under the Code, subject to certain conditions.

In the preamble to the U.S. TLAC Proposal, the staff of the Board explains that the Prohibition on Guarantees is intended as a "complement to other work that has been done or is underway to facilitate SPOE resolution through the stay of cross-defaults, including the [ISDA 2014

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6 As part of the overall goal of addressing the issues raised by cross-default rights, ISDA is developing a separate protocol that will allow all market participants to satisfy the requirements of regulations in different jurisdictions, including U.S. Resolution Stay Regulations, once they are adopted.

7 See ISDA 2015 Universal Resolution Stay Protocol Attachment § 4(a)(ii).

8 See U.S. TLAC Proposal §§ 252.64(a)(4) (prohibition applicable to Covered BHCs) and 252.165(d) (prohibition applicable to Covered IHCs).

Universal Protocol]."[9] However, if the Prohibition on Guarantees is inconsistent with the Bankruptcy Code Provisions and U.S. Resolution Stay Regulations, it will undermine rather than complement those efforts and render the Bankruptcy Code Provisions and the expected U.S. Resolution Stay Regulations meaningless for many adhering parties. As an example, if a Covered BHC guaranteed the obligations of an affiliate and the obligation was amended to comply with U.S. Resolution Stay Regulations, the obligation could contain non-compliant cross-default clauses and the Covered BHC would be in violation of the Prohibition on Guarantees.[10]

We believe that the Board should not impose such prohibitions prior to publishing and adopting the U.S. Resolution Stay Regulations. This will also allow the Board to benefit from a separate notice and comment period with respect to the complicated issues surrounding stays on cross-default rights. If the Board does retain the Prohibition on Guarantees, however, we at least urge the Board to clarify that a Covered BHC or Covered IHC would not be in violation of such prohibition if the underlying obligation complies with U.S. Resolution Stay Regulations. In addition, we understand that the U.S. Resolution Stay Regulations may be limited in scope to "qualified financial contracts" ("**QFCs**"), whereas the Prohibition on Guarantees applies to any type of liability, not just QFCs. We would also, therefore, urge the Board to take a consistent view about the treatment of insolvency-based cross-defaults with respect to all types of liabilities.

III. The Board Should Clarify the Prohibition on Covered BHCs and Covered IHCs Entering into Third-Party QFCs

The clean holding company requirements of the U.S. TLAC Proposal would also prohibit Covered BHCs and Covered IHCs from entering into QFCs with third parties.[11] QFCs are defined by reference to the Orderly Liquidation Authority, pursuant to which a guarantee or other credit enhancement ("**Credit Enhancement**") of a QFC would itself fall within the definition of a QFC.[12] The apparent result of this definition, in combination with the prohibition

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9 80 Fed. Reg. at 74946.

10 We note that the Bankruptcy Code Provisions would address the concerns about insolvency-based cross-default rights raised by the staff of the Board in the preamble to the U.S.TLAC Proposal. The Board explains that the Prohibition on Guarantees is driven by the goal of preserving the operations of a Covered BHC's subsidiaries if the Covered BHC entered resolution, which "would be jeopardized if the [Covered BHC]'s entry into resolution or insolvency operated as a default by the subsidiary and empowered the subsidiary's counterparties to take default-related actions, such as ceasing to perform under the contract or liquidating collateral." 80 Fed. Reg. at 74946. However, if the underlying obligation was subject to the ISDA 2015 Universal Protocol, the Board's concerns would not be implicated because once the Covered BHC entered into insolvency proceedings, the subsidiary's counterparty would be stayed from exercising its insolvency-based cross-default rights and would therefore not be able to take "default-related actions" with respect to the subsidiary.

11 U.S. TLAC Proposal § 252.64(a)(3) (Covered BHCs); § 252.165(c) (Covered IHCs).

12 12 U.S.C. § 5390(c)(8)(D). The definition of "qualified financial contract" includes any security agreement or arrangement or other credit enhancement related to an agreement or transaction that is otherwise a QFC, including any guarantee or reimbursement obligation in connection with such QFC.

of third-party QFCs, would be that a Covered BHC or Covered IHC would not be allowed to provide Credit Enhancements in connection with a QFC of an affiliate with a third party.

We believe that the Board did not intend to prohibit Covered BHCs and Covered IHCs from providing Credit Enhancements in connection with affiliate QFCs. Indeed, prohibiting all parent Credit Enhancements of affiliate QFCs would appear to be inconsistent with the Prohibition on Guarantees discussed above that would allow Covered BHCs and Covered IHCs to guarantee affiliate liabilities to third parties, so long as such guarantees did not contain certain cross-defaults.

Further, the Board explains that the prohibition on third-party QFCs in the U.S. TLAC Proposal is driven by a concern that a financial institution with a material amount of QFC exposure would pose a risk to financial stability because it is likely that "many of that institution's QFC counterparties would respond to the institution's default by immediately liquidating their collateral," which could have adverse effects on the U.S. economy.[13] If the Covered BHC or Covered IHC entered Orderly Liquidation Authority proceedings, the Federal Deposit Insurance Corporation would have the ability to override the counterparty's cross-default rights. The same outcome would arise if the underlying QFC was subject to the ISDA 2015 Universal Protocol or similar terms and the Covered BHC or Covered IHC entered into proceedings under the Code.

For the foregoing reasons, we respectfully request that in the final rules the Board clarify that, for purposes of the clean holding company requirements, Covered BHCs and Covered IHCs would not be prohibited from providing Credit Enhancements with respect to the QFCs of an affiliate, subject to the other limitations of the final rules. As we note above, we believe that Covered BHCs and Covered IHCs should be permitted to provide Credit Enhancement in respect of any obligation of an affiliate so long as that obligation's insolvency-based cross-defaults are compliant with U.S. Resolution Stay Regulations.

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ISDA appreciates the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,

Katherine Darras
General Counsel, Americas

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13 80 Fed. Reg. at 74945.